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Park Electrochemical Corp. et. al v. Delco Electronics Corp.,
Nos. 01-15326; 01-15690

CATHY A. CATTERSON
U.S. COURT OF APPEALS

TALLMAN, Circuit Judge, dissenting in part:

Because I believe Nelco was prejudiced by an erroneous jury instruction on the breach of contract claim, I respectfully dissent from Section 1 of the memorandum disposition. Nelco timely objected to the proposed instruction and sought additional language which would have ameliorated the error, satisfying the requirements of Rule 51. See Fed. R. Civ. Pro. 51.

The district court instructed the jury on the breach of contract claim as follows:

In its breach of contract claim, Nelco claims that Delco breached the 1996 extension to the 1994 requirements contract, when Delco stopped purchasing mass laminate from Nelco in May 1998. To establish its breach of contract claim, Nelco must prove by a preponderance of the evidence that Delco did not act in good faith when it stopped purchasing mass laminate from Nelco and that Nelco was damaged by Delco's alleged breach.

"Good faith" means honesty in fact and the observance of reasonable commercial standards of fair dealing in the trade. A buyer under a requirements contract may not reduce or eliminate its requirements solely to avoid its contract with seller. *A buyer under a requirements contract acts in good faith if the buyer has a legitimate business reason for eliminating its requirements for the seller's goods.*

The error in this case was instructing the jury that it need only find that Delco had a legitimate business reason for terminating the contract to rule in Delco's favor.

At a minimum, the court needed to define “legitimate.” As it stood, the instruction erroneously permitted the jury to conclude that *any* business reason for terminating the contract (including the desire for greater profitability) was valid. The instruction effectively created an option contract for Delco, which the case law has uniformly held a requirements contract is not. See, e.g., Empire Gas Corp. v. American Bakeries Co., 840 F.2d 1333, 1340 (7th Cir. 1988).

A

As a matter of common-sense, for the buyer to terminate a requirements contract in good faith, more than some “business reason” must be proffered. Presumably, every buyer is a rational capitalist, and every action taken by the buyer is for the purpose of improving its profit margin. Applying that logic, a business reason will *always* underlie the termination of a requirements contract. The limited case law concerning requirements contracts and the Official Comments to UCC § 2-306 recognize this tautology and hold that for a buyer to terminate a requirements contract in good faith, the buyer must be motivated by more than a desire for greater profitability.

The leading requirements contract case is Empire Gas Corp. 840 F.2d 1333. Empire Gas concerned the same issue presented in this appeal: whether a requirements contract is “essentially a buyer’s option,” allowing the buyer to

purchase all of the goods he needs from the seller or none at all. Id. at 1334. That court concluded that a requirements contract is not an option contract for the buyer in that the buyer is bound by good faith and may not arbitrarily reduce his requirements to zero. The good faith calculus requires that both the buyer and the seller assume certain risks. “The seller assumes the risk of a change in the buyer’s business that makes continuation of the contract unduly costly, but *the buyer assumes the risk of a less urgent change in his circumstances . . .*” Id. at 1340 (emphasis added).

Thus, the exigency of the buyer’s change of circumstances is critical when determining good faith. Id. The exigency “need not be so great as to give [the buyer] a defense under the doctrines of impossibility, impracticability, or frustration, or under a *force majeure* clause. Yet, although more than whim is required, how much more is unclear.” Id. (citation omitted). “[A]t a minimum,” however, “the reduction of requirements [must] not have been motivated solely by a reassessment of the balance of advantages and disadvantages under the contract to the buyer.” Id. at 1341.

Empire Gas thus stands for the proposition that a buyer must experience some measurable change in circumstances to show that it acted in good faith when it terminated the requirements contract. Several decisions support this common

sense recognition of business contracting. See, e.g., Schawk, Inc. v. Donruss Trading Cards, Inc., 746 N.E.2d 18, 26 (Ill. Ct. App. 2001) (noting that “more than minor changes in [the buyer’s] economic circumstances is necessary to show good faith”); Technical Assistance Int’l v. United States, 150 F.3d 1369, 1372 (Fed. Cir. 1998) (explaining that to act in good faith, a buyer must have a “valid business reason” “other than dissatisfaction with the contract”); Agfa-Gevaert A.G. v. A.B. Dick Co., 879 F.2d 1518, 1522 (7th Cir. 1989) (buyer may reduce or eliminate requirements in good faith if there is a change in his business); Tennessee Valley Authority v. Imperial Professional, 599 F. Supp. 436, 439 (E.D. Tenn. 1984) (noting that courts have generally allowed buyers to eliminate their requirements if there is a “bona fide decrease” in need for the goods); see also Official Comment 2 of U.C.C. § 2-306 (“A shut-down by a requirements buyer for lack of orders might be permissible when a shut-down merely to curtail losses would not.”).

In sum, the buyer’s desire for greater profitability, standing alone, is insufficient to establish that the buyer acted in good faith in terminating the requirements contract. Here, the last sentence of the instruction misleadingly informed the jury that it must rule in favor of Delco if the jury found that Delco terminated the contract in order to enhance its bottom line. That was prejudicial error.

B

The instruction also failed to consider the interplay between UCC § 1-203 (A.R.S. § 47-1203) and § 2-306 (A.R.S. § 47-2306). Section 1-203 sets forth the parties' general obligation of good faith. For the purposes of § 1-203, good faith is defined as "honesty in fact and the observance of reasonable commercial standards of fair dealing in the trade." § 2-103(1)(b).¹ Breach of this general obligation of good faith *is* a breach of the contract. See Official Comment to § 2-103. In order to comply with this contract, then, Delco was required to (1) be honest in fact, and (2) observe reasonable commercial standards of fair dealing.

In this case the jury instruction obliquely acknowledged the requirements of § 1-203, but was not sufficiently specific, and the last sentence of the instruction effectively obliterated the overarching good faith requirement of § 1-203. The negation of the § 1-203 language was prejudicial error.

The jury should have been instructed that Delco breached the contract if any of the following three things occurred:

- (1) Delco was not honest in fact in its dealings with Nelco; or
- (2) Delco failed to observe reasonable commercial standards of fair

¹I am assuming that both the parties here are merchants. See § 2-104. For non-merchants, UCC § 1-201(19) governs. That section provides that good faith is "honesty in fact."

dealing in its performance of the contract; or

- (3) The changes in Delco's business circumstances were not substantial enough to validate terminating the requirements contract.

C

The jury's verdict in favor of Nelco on the breach of the implied covenant of good faith and fair dealing claim demonstrates that the error in the breach of contract instruction was not harmless. On the implied covenant claim, the jury was instructed that "The duty to act fairly and in good faith requires that neither party do anything that prevents the other party from receiving the benefits to which it is entitled under the contract." Certainly, the UCC's duty of good faith is different from that imposed under the common law. But the jury's verdict suggests that it did not approve of Delco's performance under the contract. This raises a strong inference that the jury did not believe Delco was honest in fact with Nelco and/or Delco did not observe reasonable commercial standards of fair dealing.

D

The memorandum disposition holds that Nelco was not prejudiced in any event because the breach of contract instruction offered by Nelco "simply repeated, in slightly different words, the explanation contained in the jury

instructions given.” I respectfully disagree. Nelco proposed adding a sentence to the end of the instruction stating: “A buyer may not eliminate its requirements because of a reassessment of the advantages of the contract.” Though perhaps inelegant, at least Nelco’s proposed instruction would have informed the jury that a requirements contract is not an option contract in favor of the buyer.

Because the error in this case was not harmless, I would reverse the jury verdict in favor of Delco on the breach of contract claim and remand for a new trial.